Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SJ:POSTF-126523-02
LBBelote

date: July 19, 2002

to: Examination Division, [redacted]
Attn.: [redacted], Team Coordinator
EXAM-[redacted]

from: LAURA B. BELOTE
Attorney (LMSB)

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subject: [redacted] Corporation
EIN: [redacted]
[redacted] **and subsequent years**

This memorandum responds to your request for assistance dated July 3, 2002. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

Exam has requested Counsel advice regarding the following two issues:

1. Whether [redacted] Corporation (the "taxpayer") is entitled to take a deduction for I.R.C. §197 amortization on intangible assets that arose from a stock purchase of a foreign corporation which was later domesticated.

2. Whether, if the taxpayer should have recognized dividend income in [redacted] upon the domestication of the foreign corporation, the I.R.C. §197 amortization should be disallowed under the tax benefit doctrine.

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CONCLUSIONS

1. The taxpayer may take a deduction for I.R.C. §197 amortization on intangible assets that arose from a stock purchase of a foreign corporation (the "target") which was later domesticated. As a result of the I.R.C. §338(g) election, the target would be treated as having sold all of its assets at the close of the acquisition date for their fair market value in a single transaction to a new corporation ("new target"). The income from the deemed I.R.C. §338 sale would be reported on the old target's foreign tax return, and would be recognized by the former shareholders of the target, rather than by the taxpayer. Additionally, as a result of the I.R.C. §338 election, the new target would obtain a stepped-up basis in its assets equal to their fair market value. This result is not changed by the fact that the foreign target subsequently became a domestic entity. The taxpayer should use the I.R.C. §338 stepped-up basis for amortization purposes.

2. The domestication of the target corporation on [redacted] required the taxpayer to recognize the target's all earnings or profits amount, consisting of the foreign earnings and profits of the target which accrued while the taxpayer held the stock. Accordingly, the income of the taxpayer for the tax year [redacted] should have been adjusted to include this amount. However, the statute of limitations for such adjustment has expired. Consequently, this adjustment has been lost unless the amount omitted from gross income constituted an omission in excess of 25 percent. If this is the case, then the statute of limitations would be six years under I.R.C. §6501(e). **The revenue agent should verify that the "all earnings and profits amount" is less than 25 percent of the stated gross income amount as the six-year statute of limitations has almost run.** The amortization issue does not have any connection with the I.R.C. §367(b) issue. Thus, the fact that the taxpayer did not report the target's "all earnings or profits amount" does not alter its entitlement to take deductions for I.R.C. §197 amortization on intangible assets. The tax benefit doctrine should not be used.

FACTUAL SUMMARY

The facts, as we understand them, are as follows. [redacted] Corporation (the "taxpayer"), is a domestic corporation within a consolidated group. On [redacted] the taxpayer purchased all of the stock of [redacted] (the "target"), a foreign corporation, for $[redacted] and approximately $[redacted] of assumed liabilities. [redacted]. There are no facts that indicate that the target had any income that was effectively connected with the conduct of a U.S. trade or business. On [redacted], a Form 8023-A containing an I.R.C. §338(g) election for the target was filed by the taxpayer. [redacted] later, the taxpayer domesticated the target. On [redacted], the taxpayer filed a consolidated [redacted] Form 1120, which included the activities of the target for the period [redacted] to [redacted]. A copy of Form 8023-A dated [redacted] was included with the consolidated return.

According to the agent, for book purposes, the acquisition transaction was valued by the taxpayer as follows: The purchase price of $[redacted] was composed of:

Book value/ FWV of assets net of liabilities (other than acquired intangibles)	$[redacted]
In Process R&D	$[redacted]
Goodwill	$[redacted]
Less Acquisition Liabilities	$[redacted]
	$[redacted]

The GL entries for the taxpayer and the target were as follows:

Parent:

Investment in Target	$[redacted]	
Cash		$[redacted]

Target:

Net assets (other than acquired intangibles)	$[redacted]	
In Process R & D[1]	$[redacted]	
Goodwill[2]	$[redacted]	
Common Stock		$[redacted]
Acquisition Liabilities		$[redacted]

For tax purposes, pursuant to the I.R.C. §338(g) election, the

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[1] The in-process R & D was treated as an expense for book (financial statement) purposes. Since this occurred while the target was a foreign corporation, there were no tax consequences in the U.S.

[2] The goodwill was amortized for book purposes over [redacted] at $[redacted].

taxpayer valued the acquired intangibles (based on a valuation study performed by KPMG, an accounting firm) as follows:

Technology	$[redacted][3]
Goodwill	$[redacted]
	$[redacted]

The agent agrees with these values. Based on the I.R.C. §338(g) election, the target, which is now within the taxpayer's consolidated group, is claiming amortization of I.R.C. §197 intangibles (goodwill and technology) totaling approximately $[redacted] over a [redacted] period.

This issue was previously considered as an informal claim during an audit of the [redacted] tax year. The taxpayer sought an amortization expense for the intangible assets which was not claimed on the originally filed [redacted] consolidated Form 1120. The taxpayer's previous position was that the $[redacted] that was written off by the target occurred while the target was a foreign entity. Therefore, there was no benefit for U.S. tax purposes. Only the difference between the $[redacted] and $[redacted] was being amortized by the taxpayer, beginning in the [redacted] tax year. Accordingly, the taxpayer originally reported amortization expenses in the amount of $[redacted] for the [redacted] tax year and $[redacted] for the [redacted] tax year. Upon further review, the taxpayer changed its position and now believes that the full $[redacted] is subject to amortization due to the I.R.C. §338(g) election, beginning with the [redacted] tax year. Consequently, the taxpayer filed amended returns claiming an amortization expenses of $[redacted] for [redacted] and $[redacted] for subsequent years. The Examination team allowed the amortization expense for one month in [redacted] based on the domestication date of [redacted]. No dividend was recognized in [redacted] by the taxpayer in connection with the domestication of the target.

The statute of limitations for the taxpayer [redacted] Form 1120 expired on [redacted]. However, the statutes for all subsequent tax years are open until at least [redacted].

LEGAL ANALYSIS

Exam contends that the taxpayer should not be permitted to include the I.R.C. §197 amortization of the acquired intangibles

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[3] The $[redacted] amount consists of $[redacted] of in-process technology and $[redacted] of manufacture technology.

on its consolidated return. Exam reasons that, first, if the target had been a domestic corporation and no I.R.C. 338(g) election had been made, then no I.R.C. §197 intangibles would have been created since the carryover basis of the target's assets would be used for purposes of depreciation and amortization. Also, if the target was a domestic corporation and an I.R.C. §338(g) election had been made, I.R.C. §197 intangibles may be created but the target would recognize gain in a manner that would have tax consequences within the U.S. In contrast to these two situations, the taxpayer made an I.R.C. §338(g) election relating to its acquisition of a foreign target. By virtue of the target's foreign status, the taxpayer did not recognize gain in a manner having U.S. tax consequences. However, due to the §338(g) election, each of the target's I.R.C. §197 intangibles received a step-up in basis which the taxpayer is using for amortization purposes. Exam believes that the purpose of I.R.C. §338 implies symmetrical tax consequences to the U.S.; that is, if the target gets the step-up in basis and resulting amortization expense on a U.S. consolidated return, then gain should also be recognized by the target in a manner that would have tax consequences within the U.S. Further, Exam deems it unfair that a stock purchase of a foreign corporation should have more advantageous tax consequences than a stock purchase of a domestic corporation. Consequently, Exam contends that the I.R.C. §197 amortization should be disallowed. Exam has also inquired whether, if the correct result is that the taxpayer should have recognized dividend income in [redacted] upon the domestication of the target, the I.R.C. §197 amortization be disallowed under the tax benefit doctrine since no dividend was recognized.

Our office has previously provided a response in an NSAR to the first issue of whether the taxpayer may amortize I.R.C. §197 intangible assets that arose from a stock purchase of a foreign corporation which was later domesticated. This office issued an NSAR to the agent addressing whether the I.R.C. §338(g) election made by the taxpayer for the target entitled the target to a step-up in basis allowing amortization of I.R.C. §197 assets, even when the foreign target is later domesticated. The NSAR concluded that, as the foreign target was 100% foreign-owned, held no U.S. real property interests, was not engaged in U.S. business and held no assets that would produce U.S. income if sold when purchased, no U.S. tax consequences resulted from either the stock sales or the target's deemed asset sales under I.R.C. §338. The result under I.R.C. §338 was not changed by the fact that the foreign target subsequently became a domestic entity. Therefore, we concluded that the taxpayer should use the I.R.C. §338 stepped-up basis for amortization purposes. This

NSAR was reviewed by the Corporate Division of the National Office, which concurred with our conclusion. The NSAR is attached for reference.

Regarding the second issue, we believe that there would be U.S. tax consequences following the domestication of the foreign target. As we noted in the NSAR, the target would qualify as a controlled foreign corporation ("CFC") following its 100% acquisition by the taxpayer on [redacted]. As a result, the domestication of the target corporation on [redacted] created a transfer subject to I.R.C. §367(b), which code section denies the benefits of nonrecognition treatment when an exchange involving a foreign corporation allows the foreign corporation to avoid U.S. taxation. As a result of that transfer, a U.S. corporation owning shares of the domesticating corporation must include in its income its "all earnings and profit amount," which would consist of the foreign earnings and profits of the target which accrued while the taxpayer held the stock. Treas. Reg. §7.367(b)-7(c)(2)(i) (as in effect in 1996). This amount would be characterized as a deemed dividend to the taxpayer during the year of domestication.

The agent has informed our office that the taxpayer did not include the target's all earnings and profit amount in gross income during the tax year [redacted] Consequently, for the purpose of determining the extent to which gain is recognized on the exchange, the target will not be considered to be a corporation. However, the applicable provisions of the Code other than §§354 or 356 shall apply as if the foreign corporation were considered a corporation. For example, I.R.C. §§358, 362 and 381, if applicable, shall apply as if no gain had been recognized. Treas. Reg. §7.367(b)-7(c)(2)(ii) (as in effect in 1996). The taxpayer's income for the [redacted] tax year could have been adjusted to include the all earnings or profits amount, but the statute of limitations for [redacted] ran on [redacted]. Unless the six-year statute of limitations (as described in I.R.C. §6501(e)(1)) applies, then the adjustment has been lost. We contacted Robert W. Lorence, CC:INTL, who concurred with the above analysis of the second issue.

We do not believe that the use of the tax benefit doctrine to deny the I.R.C. §197 amortization would be appropriate in this case. The tax benefit rule is a judicially developed doctrine that is designed to relieve some of the inequities that can result from strict adherence to an annual accounting system.

Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983). The rule has two aspects. See, e.g., Renner v. Comm'r., T.C. Memo. 1994-263. First, under the inclusionary aspect of the rule, a taxpayer is required to include in gross income any amount recovered in the current year for which a deduction was claimed in a prior year. Under the exclusionary aspect of the rule, the inclusion is limited to amounts from which a taxpayer derived a tax benefit in the prior year. The exclusionary aspect of the tax benefit rule is codified in I.R.C. §111.

In this case, the fact that the taxpayer did not report the "all earnings and profits amount" as it should have does not affect the fact that the target received a step-up in basis of each asset. The taxpayer would still be able to use this stepped-up basis for amortization purposes. As stated above, the subsequent domestication of the foreign target does not negate the I.R.C. §338(g) election. Also, although the foreign target had previously expensed technology and amortized goodwill for book purposes, this expense and amortization did not result in a deduction for tax purposes. Under the tax benefit rule, recoveries must be included in income only if attributable to deductions or credits claimed in a previous tax year. These amounts are included only to the extent that the deductions or credits actually reduced income tax in the earlier year. In other words, although the tax benefit rule requires inclusion in income of recoveries related to prior deductions or credits, the amount included is limited by the taxpayer's actual tax benefit. See, e.g., Continental Illinois National Bank and Trust Company of Chicago v. Commissioner, 67 T.C. 357 (1977), Acq. by Comm'r., 1978-2 C.B. 1 (I.R.S. 1978).

Please note that a copy of this memorandum will be forwarded to our National Office to ensure that the above analysis is consistent with the National Office position. We will notify you within approximately two weeks if the National Office believes that our analysis should be revised.

If you have any questions or concerns, please do not hesitate to contact the undersigned attorney at (408) 817-4694.

Associate Area Counsel
(Large and Mid-Size Business)

By:______________________________
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